Box 3

Changed method of calculating mortgage interest cost in the housing component of the CPI

Rises in the housing component of the CPI have been the main driver of inflation over the past year. Excluding this component, the CPI in May 2005 was unchanged year-on-year. This has prompted some debate about the methods used for calculating the housing component. They have been discussed in Monetary Bulletin and were also referred to by the Chairman of the Board of Governors of the Central Bank of Iceland in his address to the Bank's annual meeting on March 30 this year (see pp. 47-56). As of May 2005 Statistics Iceland changed the method of averaging real interest rates in the model which determines the user cost of owner-occupied housing in the CPI. This resulted in a CPI measurement that was 0.45% lower than would otherwise have been the case, while the headline CPI fell by 0.54% from April. The significance of this change from the perspective of monetary policy is discussed on p. 37. The following is Statistics Iceland's announcement of the change, published in its monthly statistics (Hagtíðindi) on May 3:

"In July 2004 the Housing Financing Fund (HFF) changed its long-term housing credit system with the introduction of cash mortgage loans (HFF mortgage bonds) carrying a lower real rate of interest than before. Shortly afterwards the banks began offering competitive mortgage loans, which greatly increased the supply of long-term credit to households. Housing transactions increased as a result and housing prices soared.

"Statistics Iceland took into account the fall in interest rates caused by this structural change in July 2004, since it reduced the level of real interest rates. In the new mortgage loan system, interest rates are determined on a monthly basis. Initially, mortgage rates were expected to change much more frequently than before, which might give rise to month-to-month volatility in the CPI. For this reason, it was decided in August 2004 to calculate real interest rates in the index as a five-year moving average, updated on a monthly basis. This would ensure that the impact of the interest rate reduction would be reflected in the calculation without interest rate changes causing short-term volatility in the index. Mortgage interest rates decreased from 5.1% to 4.8% in July 2004 and had gone down to 4.15% at the end of the year. They have remained unchanged since and are likely to have stabilised at a lower level in real terms.

"In light of this experience and perspectives that have been expressed, Statistics Iceland considers that the term of the moving average for interest rates should be shortened to twelve months, thus incorporating the effect of changes into the calculation more quickly. The new method will be applied until the CPI is rebased in March 2006, when it will be reconsidered. If interest rates remain stable over this period, the impact of the change in interest rates on inflation measurements will be neutralised.

"The composition of real interest rates used for the calculation has also been reviewed, as is done every March in the annual rebasing of the index. Interest rates on own financing of housing, which account for just over half the weight of interest rates in the housing component, are fixed. Other interest rates are variable, and cover HFF loans, mortgage loans from banks and pension funds, and mortgage loans taken over when housing is purchased. After these changes, average interest rates are 3.7%.

"The total reduction in the CPI on account of the fall in the twelve-month moving average of interest rates amounts to 0.9% from July 2004 to April 2005 and the impact of lower interest rates which lower the CPI by 0.45% has already been included in the measurement in May 2005."